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SUBJECT: ARMENIA INVESTMENT CLIMATE STATEMENT 2008

REF: 07 STATE 158802

¶1. (U) Per reftel, Embassy Yerevan, Armenia submits the following as its 2008 Investment Climate Statement.

BEGIN TEXT

¶2. According to data from the National Statistical Service (NSS), foreign investment in Armenia has steadily increased from USD 70 million in 2001 to USD 470 million as of September 2007. From January to September 2007, Foreign Direct Investment (FDI) in Armenia totaled USD 311 million, a 209 percent increase over the same period in 2006. Major foreign investments were from Russia, Lebanon, Argentina and Germany. Gross domestic product (GDP) growth remained strong at approximately 13 percent for 2006, continuing the trend of the last 6 years. The IMF projects GDP growth of approximately 10 percent in 2008.

¶3. The largest foreign investors in Armenia are those who have acquired interests in the telecommunication, mining, energy, air transportation and financial sectors. The privatization of Yerevan's largest hotels, two historic brandy factories, the Zvartnots International (Yerevan) and Shirak (Gyumri) Airports, the telecommunications network, several mining assets and much of the energy generation and distribution system accounts for the bulk of foreign commercial presence in Armenia.

¶4. According to the NSS, FDI inflows were up by 33 percent year-on-year in the first half of 2007. Lebanon was the leading investor in this period, accounting for around one-third of the total, attributable to the fact that the Lebanese company K-Telecom owned Armenia's largest mobile phone network until Russia's MTS bought it in September. Both K-Telecom and Armentel, the national telecommunications company now owned by Russia's Vimpelcom, have been investing heavily in the expansion of their competing wireless networks. Consequently, the telecoms sector remained by far the largest recipient of FDI in January-June 2007, attracting almost 60 percent of the total. Civil aviation attracted around nine percent of total FDI, owing to the reconstruction of the capital, Yerevan's Zvartnots International Airport; construction was the third-largest destination with eight percent of FDI.

¶4. Greenfield investments consist of mostly small and medium-sized enterprises. More than a dozen U.S. information technology (IT) firms have established subsidiary operations in Armenia.

¶5. In 2007, the Armenian dram (AMD) continued to appreciate significantly, especially against the U.S. dollar, contributing to an increase of 6.8 percent in year-on-year inflation as of November 2007. The Central Bank and IMF both cite increased U.S. dollar remittance inflows as one of the primary drivers of the dram

appreciation trend. According to the National Statistical Service, as of November 30, 2007, nominal appreciation of the dram against the U.S. dollar reached about 12 percent for the year, following a 19 percent appreciation in 2006 and 7 percent in 2005. Some anecdotal data suggest that AMD appreciation in recent years has caused the decline of exports of traditional commodities, in which the export-to-import ratio in the total trade turnover is roughly 27-to-73. This will raise concerns among domestic exporters about the potential loss of competitiveness in overseas markets, particularly given the rapid rate of wage growth in Armenia.

OPENNESS TO FOREIGN INVESTMENT

¶16. Armenia's investment and trade policy is relatively open, although significant obstacles remain, particularly problems with corruption. Armenia ranked 34th out of 175 economies -- the highest ranking among CIS countries -- in the "ease of doing business" index according to the World Bank's report, Doing Business in 2007. The Armenian Government continues to work to attract additional investment. Foreign companies are entitled by law to the same treatment as Armenian companies (national treatment), and in some cases they may benefit from temporary preferential tax treatment including a two-year profit tax exemption. While this exemption was slated to phase out by the end of 2007, there is no clear indication as to how the transition will proceed.

¶18. Basic provisions regulating American investments are set by the Bilateral Investment Treaty (BIT), signed by the United States and Armenia in 1992, and by the 1994 Law on Foreign Investment. In addition to providing for national treatment and most-favored nation treatment, the BIT sets out guidelines for the settlement of disputes involving the governments of either party.

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¶19. Armenia's 1997 Law on Privatization (amended in 1999) states that foreign companies have the same rights to participate in the privatization processes as Armenian companies. Nevertheless, recent important privatizations of Armenia's large assets have not been competitive or transparent, and political considerations have in some instances trumped Armenia's international obligations to hold fair tender processes.

¶110. Under the Constitution, foreign individuals are prohibited from owning land in Armenia, but this prohibition does not apply to foreign businesses. Armenia does not issue foreign tax credits and has no double taxation treaty with the United States. To date, no cases have been identified in which U.S. entities were disadvantaged for lack of a double taxation treaty. The Armenian government has expressed interest in negotiating a double taxation treaty with the United States. The State Department and U.S. Embassy Yerevan would welcome information from American firms or individuals that would substantiate whether such a treaty would facilitate U.S. business interests in Armenia.

¶111. Armenia is a member of the following major international organizations: IMF, World Bank/IDA, IFC, WTO, OSCE, Council of Europe, UN/UNCTAD/UNESCO, MIGA, ILO, WHO, WIPO, INTERPOL, European Bank for Reconstruction and Development (EBRD), the Asian Development Bank (ADB), IAEA, World Tourism Organization, World Customs Organization, International Telecommunications Union and the Organization of the Black Sea Economic Cooperation (BSEC). Armenia became the 145th member of the WTO in February 2003.

¶112. The seemingly open legislative framework and the government's visible effort to attract more foreign investment is overshadowed by instances of unfair tender processes and preferential treatment. A few recent cases of de facto takeovers by certain investors, facilitated by senior government officials, as well as the state's failure to ensure a fair investigation and judicial review, has marred the government's assurances of equal treatment and transparency.

CURRENCY CONVERSION AND TRANSFER POLICIES

¶13. There are no limitations on the conversion and transfer of money or the repatriation of capital and earnings, including branch profits, dividends, interest, royalties, or management or technical service fees. Most banks can transfer funds internationally within 2-4 days. The Government maintains the Armenian Dram (AMD) as a freely convertible currency under a managed float. According to the 2005 law on "Currency Regulation and Currency Control," prices for all goods and services, property and wages must be set in Armenian Drams. There are exceptions in the law, however, for transactions between resident and non-resident businesses and for certain transactions involving goods traded at world market prices. The new law requires that interest on foreign currency accounts be calculated in that currency, but be paid in Armenian Drams.

EXPROPRIATION AND COMPENSATION

¶14. Under Armenian law, foreign investments cannot be nationalized; they also cannot be confiscated or expropriated except in extreme cases of natural or state emergency, upon a decision by the courts and with compensation. While the U.S. government is not aware of any confirmed cases of expropriation, a local subsidiary of a U.S.-based mining company is engaged in an ongoing dispute with the Armenian Government and has accused the latter of expropriating company assets. To date, there has been no court assessment of the company's claims. The company is seeking an amicable settlement of its dispute.

DISPUTE SETTLEMENT

¶15. According to the 1994 Foreign Investment Law, all disputes that arise between a foreign investor and the Republic of Armenia must be settled in Armenian courts. In late January 2007, however, President Kocharian signed a new law on Commercial Arbitration, which provides investors with a wider range of options for resolving their commercial disputes. The Bilateral Investment Treaty (BIT), signed by the U.S. and Armenia, provides that in case a dispute arises between an American investor and the Republic of Armenia, the investor may choose to submit the dispute for settlement by binding international arbitration. As an international treaty, the BIT supersedes Armenian law, a point which Armenia's constitution

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acknowledges and that exists in actual practice.

¶16. Many Armenian courts suffer from low levels of efficiency, independence and professionalism and there is a need to strengthen the Armenian judiciary. While there have been a few investment disputes involving U.S. and other foreign investors, there is no evidence of a pattern of discrimination against foreign investors in these cases. In general, the government honors judgments from both arbitration and Armenian national courts.

¶17. Disputes to which the Armenian Government is not a party may be brought before an Armenian or any other competent court, as provided by law or by agreement of the parties. There is a special Economic Court that hears commercial disputes. The verdict of an Economic Court can be appealed to the Court of Cassation, the highest judicial authority in Armenia. The Law on Arbitration Courts and Arbitration Procedures provides rules governing the settlement of disputes by arbitration. According to Constitutional amendments of 2005, the courts of first instance must undergo a major restructuring; as a result, in January 2008, the GOAM abolished the Economic Court and launched a new specialized administrative court and courts of general jurisdiction to hear civil and criminal cases, in the hope of streamlining these proceedings. Armenia is a party to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the Washington Convention) and the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards.

PERFORMANCE REQUIREMENTS AND INCENTIVES

¶18. Armenia currently has incentives for exporters (no export duty, VAT refund on goods and services exported) and foreign investors (income tax holidays, and the ability to carry forward losses indefinitely). The government amended the VAT law in November 2005 to allow companies to delay VAT payments for 1-2 years on certain imported goods used in production and manufacturing. Also, in accordance with the Law on Foreign Investment, several ad hoc incentives may be negotiated on a case-by-case basis for investments targeted at certain sectors of the economy and/or of strategic importance to the economy.

¶19. The Government of Armenia has imposed performance requirements for investors as part of privatization agreements, especially for the privatization of large state assets like mines or the telecommunications network. There are no performance requirements for de novo investment.

RIGHT TO PRIVATE OWNERSHIP AND ESTABLISHMENT

¶20. The Armenian Constitution protects all forms of property and the right of citizens to own and use property. Foreign individuals, who do not hold special residence permits, cannot own land, but may lease it; companies registered by foreigners in Armenia as Armenian businesses have the right to buy and own land. There are no restrictions on the rights of foreign nationals to acquire, establish or dispose of business interests in Armenia.

PROTECTION OF PROPERTY RIGHTS

¶21. Armenian law protects secured interests in property, both moveable and real. Armenian legislation provides a basic framework for secured lending, collateral and pledges, and provides a mechanism to support modern lending practices and title registration. Although the mortgage market has been slow to develop, increased competition among a number of commercial banks has led to better lending conditions with interest rates as low as 11.5 percent (compared to 16-17 percent in 2004).

¶22. Domestic legislation, including the 2006 Law on Copyright and Related Rights, provides for the protection of intellectual property rights on literary, scientific and artistic works (including computer programs and databases), patents and other rights of inventions, industrial design, know-how, trade secrets, trademarks and service marks. Armenia's legislation is in compliance with Trade Related Aspects of Intellectual Properties (TRIPS) Agreement. In January 2005, the government created an IPR Enforcement Unit in the Organized Crime Department of the Armenian Police. The onus for IPR complaints remains with the offended party; the Government of Armenia has yet to prosecute one case of IPR violations successfully. It is not yet clear, however, whether the action that it has taken represents the beginning of stronger IPR enforcement

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efforts or selective enforcement. There is also an Intellectual Property Agency in the Armenian Ministry of Trade and Economic Development responsible for granting patents and for overseeing other IPR related matters. While Armenia has made some progress on IPR issues, strengthening enforcement mechanisms remains a priority.

TRANSPARENCY OF THE REGULATORY SYSTEM

¶23. The Armenian regulatory system pertaining to business activities still lacks transparency in implementation. A small group of businesses dominate several sectors that should be competitive. The

inconsistent application of tax, customs (especially valuation) and regulatory rules, especially in the area of trade, undermines fair competition and adds uncertainty for small- and medium-sized businesses and new market entrants. Banking supervision is relatively well developed and largely in-line with the Basel Core Principles. In early 2006, the Armenian Central Bank became the primary regulator for all segments of the financial sector, including banking, securities, insurance and pensions.

¶24. Safety and health requirements, mostly remaining from the Soviet period, generally do not impede investment activities. Bureaucratic procedures can nevertheless be burdensome and discretionary decisions by individual officials still provide opportunities for petty corruption. Despite persistent problems with corrupt officials, both local and foreign businesses assert that a sound knowledge of tax and customs law and regulations enables business owners to deflect a majority of unlawful bribe requests.

CAPITAL MARKETS AND PORTFOLIO INVESTMENTS

¶25. Armenia's financial sector is not well developed. As of September 2007, total bank assets were USD 2 billion (32.9 percent of GDP), up 13.2 percent from September 2006. IMF estimates suggest that banking sector assets account for 95 percent of total financial sector assets. Financial intermediation is poor: commercial lending rates in AMD range from 17 percent to 20.8 percent. Nearly all banks require collateral located in Armenia and large collateral requirements often prevent potential borrowers from entering the market.

¶26. Although there is a system and legal framework in place, Armenia's securities market is not well developed. On November 21, 2007, OMX, a leading expert in the equities exchange industry, and the Government of Armenia signed a Share Purchase Agreement regarding the acquisition of the Armenian Stock Exchange and the Central Depository of Armenia. According to the agreement, OMX becomes the sole shareholder of the Armenian Stock Exchange (Armex) and the Central Depository of Armenia (CDA). In addition to the Share Purchase Agreement, OMX and the Government of Armenia have also signed a Cooperation Agreement outlining joint efforts to support the long-term development of the capital market in Armenia.

¶27. Remittances constitute a significant share of Armenia's total GDP. According to the latest data released by the Central Bank, the volume of private (non-commercial) remittances for January-September 2007 has increased by almost 40 percent compared to the same period in 2006. The Central Bank has forecast that remittances will reach a new, full-year high of USD 1.35 billion in 2007. The Central Bank's 2006 survey states that 37 percent of Armenian households regularly receive remittances. The most recent Central Bank data indicate that 80 percent of remittances originate in Russia and the remainder come primarily from the US and Europe.

POLITICAL VIOLENCE

¶28. We know of no incident involving politically motivated damage to commercial property in Armenia. In 2007, however, there were reports of harassment and intimidation of businessmen who have ties to an opposition candidate in the upcoming presidential election. A Presidential election is scheduled for February 19, 2008. Armenia's ceasefire with Azerbaijan has held for more than 10 years; there have been no threats to commercial enterprises from skirmishes in the border areas. It is unlikely that civil disturbances, should they occur, would be directed against U.S. businesses or the U.S. community.

CORRUPTION

¶29. Corruption remains a significant obstacle to U.S. investment in Armenia. The Armenian Government introduced a number of reforms during the last four years, including the simplification of licensing procedures, civil service reform, a new criminal code, privatization in the energy sector, anti-corruption laws and regulations, and in 2004, establishment of an Anti-Corruption Council tasked with coordinating the government's anti-corruption activities and improving policies aimed at the prevention of corruption. Nevertheless, corruption remains a problem in critical areas such as the judiciary, tax and customs operations, health, education and law enforcement. Petty corruption is widespread throughout society.

¶30. In November 2003, the GOAM adopted a National Anti-Corruption Strategy paper which contained an action plan aimed at introduction of tax and customs reforms, harmonization of legislation and improvement of public access to information. The plan, completed in 2007, was widely criticized by local and international observers. The Armenian Government has circulated a draft of a new anti-corruption strategy, which it has yet to adopt.

¶31. Relationships between high-ranking government officials and the emerging private business sector encourage influence peddling between officials and the private firms from which they benefit. Powerful officials at the federal, district or local levels acquire direct, partial or indirect control over emerging private firms. Such control is exercised through a hidden partner or through majority ownership of a prosperous private company. This involvement can also be indirect, e.g., through close relatives and friends. These practices promote protectionism, encourage the creation of monopolies or oligopolies, hinder competition and undermine the image of the government as a facilitator of private sector growth.

¶32. The Law on Civil Service, in force since January 1, 2002, restricts participation by civil servants in commercial activities. The new Law on the Disclosure of Property and Income for heads of state authorities has increased transparency in government officials' decision-making and influence. Corrupt practices exist widely within private companies as well, mostly in the form of tax fraud and unregistered business activities.

BILATERAL INVESTMENT AGREEMENTS

¶33. Armenia has bilateral investment treaties (BITs) in force with 21 countries: the U.S., Argentina, Austria, Belarus, Bulgaria, Canada, China, Cyprus, France, Germany, Greece, Georgia, Iran, Italy, Kyrgyzstan, Lebanon, Romania, Switzerland, Ukraine, the United Kingdom and Vietnam. According to the U.N. Conference on Trade and Development, Armenia has also signed BIT agreements with Belgium, Egypt, Finland, India, Israel, Russia, Tajikistan and Turkmenistan, but these agreements have not yet entered into force. Armenia is a signatory of the CIS Multilateral Convention on the Protection of Investor Rights.

¶34. The Treaty between the Republic of Armenia and the United States of America Concerning the Reciprocal Encouragement and Protection of Investment (the Bi-lateral Investment Treaty or BIT) was ratified in September 1995. The BIT sets forth investment conditions for investors of each party to be no less favorable than for national investors (national treatment) or for investors from any third state (a Most-Favored-Nation clause). It protects investment against expropriation and nationalization, and regulates dispute settlements between foreign companies and the governments of each party. Armenia does not have a bilateral taxation treaty with the United States, nor is there any indication that this lack has done any economic harm to U.S. business interests. U.S. Embassy Yerevan and the Department of State would welcome information from U.S. firms or individuals to substantiate whether such a treaty would materially facilitate U.S. trade and investment in Armenia.

OPIC AND OTHER INVESTMENT INSURANCE PROGRAMS

¶35. The "Investment Incentive Agreement between the Government of the Republic of Armenia and the Government of the United States of America," signed in 1992, provides a legal framework for OPIC's operations in Armenia. OPIC offers political violence insurance in Armenia and insures against expropriation. OPIC insures against currency inconvertibility only on a case-by-case basis. Armenia is also a member of the Multilateral Investment Guarantee Agency (MIGA).

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LABOR

¶36. Armenia's human capital is one of its strongest resources. The labor force is generally well educated, particularly in the sciences. Almost one hundred percent of Armenia's population is literate. Enrollment in secondary school is 92.8 percent and enrollment in senior school (essentially equivalent to American high school) is 85.6 percent. According to a survey by U.N. Development Program, approximately 20 percent of Armenians have completed some sort of higher education program.

¶37. Much of new foreign investment in Armenia is in the high-tech sector. High-tech companies have established branches or subsidiaries in Armenia to take advantage of the country's pool of qualified specialists in electrical and computer engineering, optical engineering and software design. Pilot training programs have increased the supply of qualified software programmers, and Armenia's IT sector is growing based on its qualified pool of inexpensive labor.

¶38. The amended Labor Code came into force in June 2005 and is considered to be largely consistent with international best practices and the international conventions to which Armenia is a party. The law sets a standard 40-hour working week with minimum paid leave of 28 calendar days annually. The draft 2008 budget, which has been approved by the National Assembly, increases the legal minimum wage to AMD 25,000, which, given the ongoing appreciation of the Armenian national currency, exceeds the formerly prevailing de facto monthly minimum wage of 50 U.S. dollars. Most companies also pay a non-official extra-month bonus for the New Year's holiday. Entry-level skilled professionals (such as software engineers) command wages of about USD500 per month. Wages in the public sector are often significantly lower than those in the private sector and, while all wages must be paid in AMD, many private sector companies continue to use a fixed exchange rate to denominate employee salaries.

FOREIGN TRADE ZONES/FREE PORTS

¶39. Armenia has no foreign trade zones or free ports at present. The company that took over management of the Zvartnots airport in June 2002 has discussed with the Armenian Government the possible establishment of a free trade zone on the territory of the airport, but such a zone has yet to be established.

FOREIGN DIRECT INVESTMENT STATISTICS

¶40. The following is volume of FDI based on data by the Armenian National Statistical Service:

Net FDI (According to IMF data)
Years 2001 2002 2003 2004 2005 2006 2007(est)
Vol(USD m) 70 111 121 217 287 305 350

¶41. In 2007, some of the most significant foreign investments for the Armenian economy came from Russia, Lebanon and Argentina. The Russian Mobile Telephone Operator Vimpelcom (operating under the Bee Line brand), which purchased 100 percent of the Armenian National Telephone operator Armentel (which itself had been acquired by the

Greek OTE company in 2006), has made significant investments to upgrade the network. [NOTE: It had previously announced plans to invest around USD 100 million in 2007 and has relinquished its monopoly over international calling and access to the internet. End Note]

¶42. Argentinian-owned Armenian International Airports Company has made considerable investments as it continues to upgrade Zvartnots International Airport. Its investment is expected to increase in 2008, once it commences renovation of Armenia's second largest airport in the north of the country.

¶43. In September 2007, another Russian telecom company, MTS, acquired 80 percent ownership in Vivacell, the second mobile operator in Armenia, with the remaining 20 percent remaining under the ownership of the Lebanese K-Telecom Company. Prior to the sale of the controlling stake to MTS, the Lebanese company had made a significant investment to expand the network further.

¶44. Dutch Haypost Trust Management, which entered into a concessionary management agreement of the Armenian postal service in

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2006, has invested around USD two million out of projected USD 10 million in upgrading the postal system and establishing local postal bank branches all over the country.

¶45. The Armenian National Statistical Service reported that total foreign investment for the first nine months of 2007 was USD 470 million, up 58 percent from the same period in 2006. Of that foreign investment, USD 311.6 million was foreign direct investment (FDI), up 209 percent compared to the previous year; FDI accounted for 4.8 percent of GDP growth in 2006 and 5.8 percent of GDP growth for the first nine months of 2007.

End text.

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